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Our ref: AA/NYK

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Dear Ms Sansom

**Response to invitation to comment on Financial Reporting Exposure Drafts 46, 47 and 48**

We welcome the opportunity to comment on the revised FREDs on the future of UK and Republic of Ireland GAAP. We commend the Board on its pragmatic response to comments received to the 2010 proposals and its willingness to develop revised proposals to meet the legitimate concerns raised by respondents.

In general, we agree with the proposals set out in the FREDs and consider they meet the ASB's objectives. In appendix 1 to this letter we set out responses to the specific questions raised in the invitation to comment. We also highlight additional comments arising as part of our review of the proposals in appendix 2, where we consider further detailed changes are necessary.

If you have any questions on the comments made, please feel free to contact me at your convenience.

Yours sincerely

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**Appendix 1 – response to questions raised in the invitation to comment**

*QUESTION 1*
*The ASB is setting out the proposals in this revised FRED following a prolonged period of consultation. The ASB considers that the proposals in FREDs 46 to FRED 48 achieve its project objective: To enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.*
*Do you agree?*

In general, we agree that the objective has been achieved, though we do have specific comments on particular requirements of the draft standards. These are considered separately at the end of our response.

*QUESTION 2*
*The ASB has decided to seek views on whether:*

> *As proposed in FRED 47 A qualifying entity that is a financial institution should not be exempt from any of the disclosure requirements in either IFRS 7 or IFRS 13; or*

*Alternatively*

> *A qualifying entity that is a financial institution should be exempt in its individual accounts from all of IFRS 7 except for paragraphs 6, 7, 9(b), 16,27A, 31, 33, 36, 37, 38, 39, 40 and 41 and from paragraphs 92-99 of IFRS 13 (all disclosure requirements except the disclosure objectives).*

*Which alternative do you prefer and why?*

We would prefer the alternative proposal, described as exempting a qualifying entity that it is a financial institution from "all disclosure requirements [of IFRS 7 and IFRS 13] except the disclosure objectives", if the specific disclosure exemptions met this description.

Requiring qualifying entities to meet only the disclosure objectives will permit such entities the flexibility to prepare their financial statements to meet the needs of users without unnecessary duplication of disclosures made elsewhere on a group basis. We do not understand why a financial institution which is a qualifying entity should be required to present more information than a financial institution permitted to apply draft FRS 102.

Under the alternative as set out above, some of the paragraphs with which such a qualifying financial institution would have to comply are detailed disclosures rather than merely disclosure objectives. For example, a qualifying entity would not be exempt from paragraphs 36 to 41 which are detailed specific disclosures rather than simply overall objectives.

In our view the provision of such disclosures in individual accounts will not always be necessary to meet the information needs of users. For example, the management of liquidity risk is likely to be performed at a group level, so there will be limited benefit in many cases from providing both parent company and group disclosures in this regard in the combined annual report (paragraph 39).

We would also note that we do not understand why the disclosure under paragraph 9(b) would be required when it refers to an amount disclosed under paragraph 9 (a) which is not required.

*QUESTION 3*
*Do you agree with the proposed scope for the areas cross-referenced to EU adopted IFRS as set out in section 1 of FRED 48? If not, please state what changes you prefer and why.*

We agree with the scope of the areas cross-referenced to EU adopted IFRS with the exception of the reference to IAS 34 for interim reports. IAS 34 assumes the application of IFRS – see IAS 34 paragraph 1 on its scope – and frequently cross-refers to those standards.

We consider a solution is readily available without reference to IAS 34, namely a reference to the ASB's Statement on Half-yearly Financial Reports. Whilst this is currently guidance rather than being mandatory for entities within its scope, we do not see why it could not become mandatory if the ASB so decided. Alternatively extracts from that statement could form part of draft FRS 102.

*QUESTION 4*
*Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.*

On balance, we agree with the definition of financial institution.

There has been some debate as to whether the definition should include such entities as single company pension schemes, small credit unions and friendly societies. It is clear that such small entities are likely to be relatively simple in their capital structures and financing arrangements. However, given the additional disclosures in section 34 are not particularly onerous, particularly where an entity is only exposed to relatively simple financial instruments and associated risks, we do not consider it necessary to further exclude some "financial institutions" on grounds of size or complexity.

However, we do not consider it necessary or appropriate to include pension schemes within the list of financial institutions. In many cases, the beneficiaries do not choose the defined benefit scheme in which contributions are made on their behalf and, in that respect, are substantively different from the other entities listed. As a pragmatic solution any additional disclosures on financial instruments that are considered necessary and relevant for pension schemes could be separately included in the part of section 34 on the financial statements of retirement benefit plans.

We would reiterate our response to question 2 that we recommend that a qualifying entity that is a financial institution applying the reduced disclosure framework in draft FRS 101 should be exempt from the majority of the specific disclosures in IFRS 7.

*QUESTION 5*
*In relation to the proposals for specialist activities, the ASB would welcome views on:*
*(a) Whether and, if so, why the proposals for agriculture activities are considered unduly arduous? What alternatives should be proposed?*

We cannot see how the requirements themselves can be unduly arduous when the recognition of an asset is only required when the fair value or the cost can be measured reliably without undue cost or effort (paragraph 34.3).

However, we would urge the board to include some guidance on what constitutes undue cost or effort, both in the context of paragraphs 34.2 and 34.3 and elsewhere in the draft standard such as section 16 on investment properties. This term is likely to be open to significant differences in interpretation from entity to entity and, potentially, between auditors, users and preparers.

*(b) Whether the proposals for service concession arrangements are sufficient to meet the needs of preparers?*

Clearer guidance should be provided on the basis of recognition and measurement of either an intangible or financial asset. Under the IFRIC 12 model, these assets arise as consideration for construction or upgrade services provided with the associated revenue recognised in accordance with IAS 11. Draft FRS 102 should clarify that the assets represent consideration for services provided and that revenue for those services be recognised in accordance with section 23.

It may also be helpful to note that the fair value of these construction services might be determined by applying an appropriate profit margin to the associated costs – this again would be consistent with IFRIC 12 in its illustrative examples.

Further guidance should also be provided on the capitalisation of borrowing costs during the construction phase. However, we would not recommend the treatment set out in IFRIC 12 which requires the capitalisation of borrowing costs when an intangible asset is recognised but does not permit such capitalisation when a financial asset is recognised. Whilst consistency with IFRS might be a valid goal, we consider there to be theoretical problems within IFRIC 12 in this regard.

IFRIC 12 requires the asset, be it a financial or an intangible asset, be recognised as the consideration for construction services, i.e. the asset is recognised by debiting the asset and crediting revenue. By corollary the costs incurred during the construction phase are recognised as work-in-progress before being released to cost of sales as construction revenue is recognised. This is consistent with IAS 18, which also considers borrowing costs to be a construction cost. Therefore, in our view, borrowing costs should not be capitalised as part of the cost of any intangible asset recognised but may be capitalised as part of the cost of work in progress.

If a mark-up is applied to these costs of construction then the asset ultimately recognised, be it an intangible or a financial asset, would be measured at the same amount.

*QUESTION 6*
*The ASB is requesting comment on the proposals for the financial statements of retirement benefit plans, including:*
*(a) Do you consider that the proposals provide sufficient guidance?*
*(b) Do you agree with the proposed disclosures about the liability to pay pension benefits?*

We consider the proposals provide sufficient guidance, subject to our comments on our answer to question 4. If, as we contend, pension schemes should not be defined as financial institutions the guidance for retirement benefit plans could be extended to include specific disclosures on financial instruments.

We recognise that while information on the value of the liability to pay pensions is useful confusion may arise in situations where the valuation method used in the pension scheme financial statements differs from that used in the sponsoring company's accounts. The Board should consider providing additional guidance on the valuation methodologies and consider the potential impacts of sponsoring company and pension scheme disclosing liabilities determined using different valuation bases.

*QUESTION 7*
*Do you consider that the related party disclosure requirements in section 33 of FRED 48 are sufficient to meet the needs of preparers and users?*

We consider the requirements in section 33 are sufficient.

*QUESTION 8*
*Do you agree with the effective date? If not, what alternative date would you prefer and why?*

We agree with the proposed effective date subject to the finalisation of the standard within 2012 and a commitment by the various SORP working parties to publish revised SORPs within a reasonable time frame sufficient to permit the relevant entities to properly prepare in advance of the first comparative period.

*QUESTION 9*
*Do you support the alternative view, or any individual aspect of it?*

Whilst we do not support all of the alternative view, we do recognise that the needs of users are important and should be considered carefully. Unfortunately, anecdotal evidence suggests that they are less vocal in responding to consultations than preparers and accounting professionals. The Board should be commended for attempting through its outreach activities to gather evidence on their needs.

Some aspects of financial reporting have become complex and, given the close relationship between many entities and their users, arguably excessively so. Accounting treatments could be identified where further simplifications could be made without reducing relevant information content for users.

However, we do recognise that the ASB does not operate in a vacuum and the development of financial reporting is a global endeavour. The specific accounting treatments proposed in draft FRS 102 and identified in the alternative view are, in the main, consistent with those applied in IFRS and US GAAP and there is benefit in achieving international consistency.

On the other hand, for many of the companies that will apply draft FRS 102, there will be little, if any, need for international comparability as their accounts will be for domestic consumption only, and then only by a small number of users. Therefore, the Board could independently develop solutions to some of the more complex accounting problems but only to the extent these were supported by users.

Without understanding the needs of users it is difficult to argue for specific changes to draft FRS 102 as set out in the alternative view, but we would urge the Board to continue with its work in areas like the accounting for income taxes and pension accounting to develop new international responses but with an objective of ensuring those responses are practical, pragmatic and understandable. We also commend the Board for its readiness to monitor developments in the accounting for financial instruments which will hopefully result in simpler hedge accounting, but urge them to consider further simplifications before finalising the new standard.

**Appendix 2 – additional comments arising as a result of our review of the proposals**

*Partial disposal of subsidiaries – paragraphs 9.18A and 9.19*

We disagree with the amendment on derivation from the IFRS for SMEs for the measurement of any retained interest to be at fair value as this would create unnecessary complexity and subjectivity. It is also inconsistent with the measurement of retained interests when a business is exchanged for an interest in a subsidiary, joint venture or associate (paragraph 9.31 (a)).

Whilst we recognise such a treatment is consistent with IAS 27 and that additional guidance on its measurement is appropriate given the IFRS for SMEs is silent on the issue, we are of the view that the retained interest should be measured at a proportionate share of the net assets of the subsidiary, including goodwill, measured at the carrying values in the consolidated statements at the date control is lost. Such an approach would be consistent with current UK GAAP and the IFRS for SMEs and creates more objective measurement.

The treatment proposed in draft FRS 102 effectively leads to the recognition of a gain or loss in the profit or loss for the period on re-measurement of the retained interest, irrespective of whether the fair value of the equity investment can be reliably measured. (NB the fair value of the retained interest might not be a simple proportion of the disposal proceeds given the premium paid by the acquirer to gain control). This is inconsistent with the subsequent measurement of such financial assets which is based on cost where their fair value cannot be reliably measured (paragraph 11.14 c (ii)).

*Investments in preference shares*

Whilst we recognise that the accounting treatment for non-convertible and non-puttable preference shares as set out in section 11 is drawn directly from the IFRS for SMEs, nonetheless we do not consider it appropriate for accounting policies to be driven by the legal form of an investment rather than its commercial substance.

The section and the IFRS for SMEs appear to assume that all non-convertible and non-puttable preference shares are equity instruments – this can be deduced by the common accounting treatment with ordinary shares and the reference in paragraph 11.11 (a) to "equity instruments other than non-convertible preference shares and non-puttable ordinary shares and preference shares".

However it is not the case that all such shares are, in substance, equity. A non-redeemable preference share with a fixed dividend is, in economic terms, substantively identical to perpetual debt with a fixed coupon rate. Similarly, a non-redeemable preference share guaranteeing the holder a share of profits is also, in substance, a liability.

In our view, the legal form of an instrument should not determine the accounting treatment by its holder but rather the treatment should be determined by the substance of the instrument's. Therefore, 11.8(d), and subsequent references, should be changed to "investments in shares which are in substance another entity's equity instruments" or similar.

We would note that we have experience of shares entitled ordinary shares that are also in substance liabilities and there are many instances of shares with titles such as "preferred ordinary shares", some of which in substance are equity and others liabilities. Whilst we note that the glossary defines the term ordinary shares as referring only to the most subordinate equity instrument, in practice the term is used more widely. The above amendment would ensure there was no confusion where preparers had failed to read the glossary.

Another problem lies with the use of the term non-puttable which is not defined. Paragraph 22.4 defines puttable financial instruments. Financial instruments that are mandatorily redeemable on a fixed date do not meet that definition. Therefore, by inference, preference shares that are mandatorily redeemable on a fixed date, that may also pay a fixed dividend, but could not be put back by the holder at an earlier date fall to be non-puttable and are within the scope of paragraph 11.8 (d) despite being economically identical to a term loan.

We also note that paragraph 11.27 is incorrect as it implies that paragraph 11.14(c)(i) requires *all* preference and ordinary shares to be measured at fair value irrespective of any of their associated rights and obligations.

*Section 15 Investments in Joint ventures*

We recommend that this section be re-written to more closely follow the requirements of IFRS 11 which does not determine the accounting of difference types of jointly controlled arrangements purely on the existence or otherwise of a separate entity. The current proposed model (derived from IAS 31) is inconsistent with IFRS 11 and current UK GAAP as FRS 9 recognises that some structures may have the form but not the substance of a joint venture.

*Presumed life of Intangibles and goodwill – paragraphs 18.20 and 19.23*

It is inevitable that there will be differences in interpretation on the adoption of draft FRS 102, but we consider the presumption of a five year life unless a reliable estimate of its life can be made is likely to be one that will create the greatest divergence in views. Given its likely importance, we urge the board to provide some interpretative guidance on what would constitute a reliable estimate in this context as a framework for substantive interpretation.

Section 19 Business Combinations and Goodwill

We recommend further guidance be added in respect of stepped or piecemeal acquisitions. We do not consider the approach of IFRS 3 (revised) should be adopted, as the rest of the proposed model is not consistent with that standard anyway and it will create further subjective measurement. However some guidance is required to mitigate the risk of divergent practices.

We recommend that paragraph 11 be amended so that an additional component of the cost of a business combination is the carrying value of any previously held equity stake. This is the same as the approach implied by the Regulations and accepted in FRS 2 as being appropriate in the generality of cases. For the sake of simplicity we would not recommend bringing forward from FRS 2 the alternative approach to measuring goodwill as set out in paragraph 89 of that standard.

*Incoming resources from non-exchange transactions*

Consistent with others operating in Public Benefit Entity sectors we are concerned that paragraphs PBE34.62 *et seq* may adversely effect the reported performance of PBEs and may lead to accounting treatments that do not present a true and fair view of their fund-raising activities.

In particular we consider further work is required on reconsidering the definitions of "restrictions" and "performance conditions", the distinctions between the two and the resulting accounting treatments.

In theory, every donation to a charity carries with it performance conditions as defined in the glossary. If the recipient charity did not use the donation to further its charitable objectives it could be called on to return the amounts received to its donors. Therefore, the distinction made between performance conditions and restrictions is a false one.

It might be argued that this issue has partly been dealt with through paragraph PBE 34B.14 in that "some requirements are stated so broadly that they do not actually impose a performance condition on the recipient". However, for this paragraph to be practical we would prefer additional guidance on what might constitute such a "broad" requirement.

Both terms already have a widely understood definition through the Charities SORP and the definitions as outlined in the proposals could be interpreted as requiring an alternative treatment than that currently followed by the PBE sector. We would recommend the Board works closely with Charities Commission and the SORP working party to develop requirements that more closely align with current accepted practice.

*Recognition of payments under an operating lease*

We recommend that "over the lease term" be added in the first sentence after "straight-line basis" to provide clarity and consistency with paragraph 20.25 on operating lease income. We note that the same inconsistency exists in the IFRS for SMEs.

*Appendix I*

The description of changes to paragraph 12.23 should be amended as that paragraph clarifies that the relevant exchange differences are NOT reclassified to profit or loss on disposal.